

DEPARTMENT OF STATE REVENUE**LETTER OF FINDINGS NUMBER: 02-20040007****Income Tax****For Tax Years 1996-2000**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES**I. Adjusted Gross Income Tax—Reclassification of Income**

Authority: The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001); 26 CFR 1.707-3; IC 6-3-2-2; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30

Taxpayer protests the reclassification of income from allocated to apportioned.

II. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is a member of a multinational group of petroleum industry companies. In 2000, taxpayer combined its assets in five states, none of which was Indiana, with another corporation to form a new partnership. The Department conducted an audit of the partnership and determined that the income from the sale of its business to the partnership was business income and issued proposed assessments on the income. Taxpayer protests the proposed assessments. Further facts will be supplied as required.

I. Adjusted Gross Income Tax—Reclassification of Income

In 2000, taxpayer contributed one hundred percent (100%) of its assets to a partnership which has Indiana nexus. The contributed property had no Indiana nexus. In return for the contribution, taxpayer received a percentage interest in the partnership plus cash of which a percentage was deemed to be gain on sale of assets under I.R.C. § 707-3. As a result of joining the partnership, which had Indiana nexus, taxpayer began filing Indiana returns in 2000. The Department conducted an audit and, noting that taxpayer reported the gain on sale amount as taxable income on its Federal return and that taxpayer included the gain on sale amount in the denominator of the sales factor of the Indiana apportionment formula on its Indiana return,

issued proposed assessments on the Indiana-apportioned percentage of the gain on sale amount as business income.

In determining that the gain on sale amount was business income, The Department relied upon 45 IAC 3.1-1-29 in determining that the income in question was business income. 45 IAC 3.1-1-29 states:

“Business Income” is defined as income from transactions and activity in the regular course of the taxpayer’s trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer’s regular trade or business. Nonbusiness income means all income other than business income. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises in from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “nonbusiness income” is the identification of the transactions and activity which are the elements of a particular trade or business.

Further guidance in determining business income under Indiana law is found in The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), in which the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

In May, the court looked to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or business income under the transactional test. These regulations state, “the critical element in determining whether income is ‘business income’ or ‘nonbusiness income’ is the identification of the transactions and activity which are the elements of a particular trade or business.” Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer’s trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer’s purpose in acquiring and holding the property producing income. In May, the court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

In this case the transaction was the sale of taxpayer’s entire operation to the partnership. Taxpayer had been in the business of producing and selling petroleum products, but the final act of taxpayer’s business was to sell everything it had to the partnership. Unlike the company in May, taxpayer here was not forced to sell its business. Taxpayer chose to change its business from producing and selling petroleum products to becoming a partner in a partnership. This is the exact opposite of the case in May. Here, taxpayer opted to get into the business of selling

entire divisions and all other aspects of its business. The gain on the sale amount was income from this business action. As provided in May, this passes the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. 664. The court in May defined "integral" as necessary or essential to complete the whole. Id. at 664-5. The court held that May's sale of one of its retailing division was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

In this case, taxpayer's sale of its entire operation to the partnership was necessary and essential to its regular trade or business since it abandoned its previous business of producing petroleum products and entered into the business of being a partner in a partnership. Under the definition supplied by the court in May, in this case it was integral to taxpayer's business to sell its property to the partnership and it was therefore necessary and essential to complete the whole of becoming a partner in that partnership. Consequently, under May, the gain on sale amount is business income.

The Department then determined taxpayer's adjusted gross income under IC 6-3-2-2(a), which states in relevant part:

With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

- (1) income from real or tangible personal property located in this state;
- (2) income from doing business in this state;
- (3) income from a trade or profession conducted in this state;
- (4) compensation for labor or services rendered within this state; and
- (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana.

...

Taxpayer protests the assessments on the grounds that it had no nexus with Indiana prior to the contribution of assets and reception of the partnership interest. The relevant statute is IC 6-3-2-2(b), which states in relevant part:

Except as provided in subsection (I), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3).

...

Taxpayer believes that IC 6-3-2-2(I) provides the appropriate method of calculating its adjusted gross income. IC 6-3-2-2(I) states:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
 - (2) the exclusion of any one (1) or more of the factors;
 - (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana;
- or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Department noted that taxpayer listed the gain on sale amount as nonbusiness income on its return, but also included the gain on sale amount in the denominator of the sales factor calculation. Taxpayer states that the gain on sale amount was listed on the return as nonbusiness income simply due to a lack of an appropriate column to list the income on the return. Taxpayer also states that the inclusion of the gain on sale amount in the denominator of the sales factor was inadvertent and is easily correctable.

There is no need to use an alternate calculation method for taxpayer's adjusted gross income. The Department is not allocating the gain on sale amount wholly to Indiana, since it is business income as defined in May. Business income is fairly apportioned to Indiana based on the three factor formula provided in IC 6-3-2-2(b). It is not relevant that the property sold to the partnership had no Indiana nexus, since its sale produced business income subject to apportionment. The apportionment of the gain on sale amount was proper and the Department properly imposed adjusted gross income tax on the Indiana apportioned amount of taxpayer's business income.

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Negligence Penalty

The Department issued proposed assessments and the ten percent (10%) negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). Taxpayer has not established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.